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CURRENCIES AND CREDIT MARKETS

No. 228 / April 1992

"It is the aim of good governments to stimulate production, of bad governments to encourage consumption; for the difficulty lies in supplying the means, not in stimulating the desire of consumption."

A Treatise on Political Economy, Jean-Baptiste Say
1803, Reprint, Kelly New York, 1971, p. 139.

HIGHLIGHTS

Worldwide, the great white hope is a U.S. recovery. As economic growth slows around the globe, all eyes are affixed on the first hopeful statistic that may herald a U.S.-led recovery. Contrary to all hopes, we still don't see any sign of anything that might be called a "recovery."

We do not dispute the possibility of a short, temporary economic rebound taking place in the U.S., much in the same form as happened last year. It might be remembered, though, that even during the 1929-30 depression each year witnessed an aborted recovery.

Europe's recent economic boom, which in its final phase was mainly driven by the temporary demand impulse that was triggered by German unification, is over, as was to be expected. For the time being there is little to cheer about.

On both sides of the Atlantic, the hope is that exports will spark a recovery. In our view, this is no time to hope for an export-led recovery anywhere. It's clearly evident that the world economy is becoming pretty much synchronized towards general weakness.

Dollar bulls abound. Almost all forecasters continue to see a rising U.S. dollar. Their first error is misjudging the Bundesbank's response to the German economy's slowdown.

Though German GNP growth distinctly peaked in the middle of last year, lower short-interest rates in Germany aren't in sight by a long shot. The Bundesbank hasn't the slightest room to ease as far as the eye can see.

All the key elements that frame the U.S. economy's long-term growth trend, as well as those of the other English-speaking economies, remain very unconstructive. That means that North American interest rates must tend to stay low over the foreseeable future.

The U.S. is in a credit deadlock of unprecedented length and severity. If there is no immediate and dramatic change for the better, it means the death knell for the U.S. recovery. The renewed slump of the broader money aggregates over recent weeks makes that outcome even more certain.

World stock markets remain precarious. Japan's progressive financial meltdown and emerging bank problems around the world speak of ever-heightening risk. In this environment, we can only recommend top quality bonds in Europe.

THE WORRIES GO GLOBAL

International financial markets started the year with two big bets: that a U.S. economic recovery was imminent thus prompting interest rates to again rise, and that recessionary tendencies in Europe would soon cause Germany to capitulate on its high interest rates. Conveniently overlooked was any potential surprises from Japan and the thought of any global slowdown. And so, bullishness on the U.S. dollar and stock markets globally — excepting Japan — sprung out all over.

Given that predisposition, a few scattered statistics — a jump in housing starts here, an unexpected rise in retail sales there — have been promptly seized upon as definite evidence that the long-forecast U.S. economic recovery is finally lifting off. We have been inclined to view these statistics as bogus. For anything worthy of a recovery to emerge what's still missing are the essential dynamics — money, credit incomes and profits. As for the German slowdown and its impact upon Europe, we have stressed that it represents not much more than a return to normal following a period of overheating due to the demand burst from East Germany . . . provided, or course, that it doesn't get much worse from here.

GLOBAL SYNCHRONIZATION ON THE DOWNSIDE

Over the years, it has become conventional wisdom that the international business cycle by necessity must be led by the U.S. economy because of its unique size. In fact, this lead-effect of the U.S. economy has been the norm throughout the whole postwar era. Whether recession or a recovery, America was always first in and first out while Europe and the rest of the industrial world always followed suit.

Europe's recent economic boom, which in its final phase was mainly driven by the temporary demand impulse that was triggered by German unification, is over, as was to be expected. For the time being there is little to cheer about. Anchored by Germany's high interest rates, other countries in Europe are unable or unwilling to attempt spurring their domestic economies by lowering their interest rates for fear of a weak currency. At the same time, these countries have little scope to ease fiscal policies — to increase government spending — not least because of the long-term budget deficit targets that have laid out at the Maastricht summit. Countries that wish to qualify for the first phase of European Monetary Union (EMU) in 1996 ideally are to have budget deficits no bigger than 2.5% of GNP.

Given no visible recovery dynamics at home, European policy-makers and forecasters are looking for outside help. By force of habit and hope, they have looked to America and the long-forecast U.S. recovery to lift the European economy out of its current stagnation.

It is this unbelievably naive belief that explains the general bullishness about the dollar. What seems preposterous is that it presupposes a vigorous U.S. recovery, a view which no longer finds any acceptance within America itself. North American forecasters assuredly still expect a recovery, only one that is more muted than the norm. What's ironic, though, is that Americans are basing their own forecasts for a U.S. recovery on strong exports to Europe which they expect will be driven by an undervalued dollar.

In our view, this is no time to hope for an export-led recovery anywhere. All in all, it's evident that the world economy is becoming pretty much synchronized towards general weakness. Eastern Europe has collapsed, both politically and economically. All of Scandinavia is mired in deep recession and crippling banking problems. Western Europe, for the present, remains caught in the grip of German monetary tightness. The Japanese powerhouse is succumbing to its savage asset price deflation. Though the Japanese trade surplus is soaring again, it's mainly due to slumping imports and not soaring exports. That's another most negative impact on the world economy.

EUROPE AND AMERICA: CRITICAL CONTRASTS

What, then, is the driving logic that underpins the U.S. recovery forecasts? It certainly has the charm of simplicity: The U.S. economy is ahead of Germany and Japan in the global business cycle and has always pulled out of recession sooner and faster than the rest of the world and therefore must do so again.

It's good to know history, but it's important to see the differences, too. The crucial point that's often mentioned but generally forgotten in application, is that the current U.S. recession is not typical of any other postwar slump. In comparing the economic situation in Europe and America, the most important difference is generally overlooked. It concerns the cause or causes of the current economic slowdown, not the timing.

In Germany and Europe, as explained, the current slowdown is clearly "policy-induced." In other words, monetary and fiscal restraint — largely provoked by Germany's inflationary and financial problems — is the "culprit." That, and little else, explains the cloud over Europe's short-term economic outlook. At the same time, it allows the comforting conclusion that the European economies will most probably rebound robustly whenever these monetary shackles are taken off.

Compared to the European scene, the U.S. economic situation is far more ambiguous and precarious. At long last, it is generally accepted that the extended downturn is largely a cause of overindebtedness and other structural impediments, the impact of which is difficult to measure on the economy. At any rate, the obvious, ominous fact is that the U.S. economy has failed to respond to an increasingly aggressive monetary easing for nearly three years. Why? We will return to this question a little later.

THE BUNDESBANK STAYS TIGHT

We come to the first miscalculation of the international dollar bulls: the Bundesbank's response to the German economy's slowdown. Though GNP growth has distinctly peaked in the middle of last year, lower interest rates aren't in sight by a long shot. The Bundesbank is confronted with three compelling reasons to stay tight: high wage demands, an inflation rate that has just hit 4.7% and excessive money and credit growth, the latter, being the chosen policy guide. Of crucial importance is the growth of M3 which is now up 9% over fourth quarter levels and is significantly above the target band of 3.5 - 5.5%. Credit is expanding at an annual rate of 12%. At these rates, the Bundesbank hasn't the slightest room to ease as far as the eye can see; neither is the prospect of any tightening being discussed.

In short, because of unification, the German economic cycle has moved sharply out of kilter with that of other industrialized countries. But while the first East German demand burst is over, the demand pull continues at a high level. Government transfers from west to east this year are soaring to over DM 180 billion from a level of DM 130 billion the previous year. As a result of generous income transfers, East German incomes are twice as high as East German production. The main beneficiaries of the demand are, of course, West German and West European producers.

It appears, moreover, that the East German economy has finally bottomed out, though not yet clearly in terms of unemployment. Led by a building boom, East German GNP is expected to rise by 10% this year. Taken together with expected growth of 1.5% in the West, that adds up to pan-German growth of 2 to 2.5%. Looking out past the current slowdown, it's very likely that long-term growth will be sustainable at 4% or more.

But inflation needs licking now. We haven't the slightest doubt that the Bundesbank will stick it out. Seldom has the Bundesbank been in a more determined mood than today, both on the domestic and international front. They know all too well that any premature easing would be sure to cause a steep decline of the D-mark against the dollar, thus giving German inflation an additional boost by driving up the prices of imported raw material.

Even though foreign pressures to ease may mount as the world economy weakens further, German public opinion sternly demands that fighting inflation has absolute priority. If the modest decline in German GNP may look like a recession statistically, it still feels more like a boom given that employment has increased by 450,000 year-over-year. The Bundesbank and most German observers simply regard the economy's current slowdown as nothing more than a return to normality following a period of overheating. The graphs on the opposite page contrast Germany's recent economic growth experience with that of the U.S. But, of course, the slowdown may not stop here. The main risk factor on the downside is a weaker-than-expected world economy hitting German exports. In our view, this risk is generally underestimated, both inside and outside Germany.

SHOULD THE U.S LOCOMOTIVE STALL AGAIN

As explained, the great white hope worldwide is a U.S. recovery.

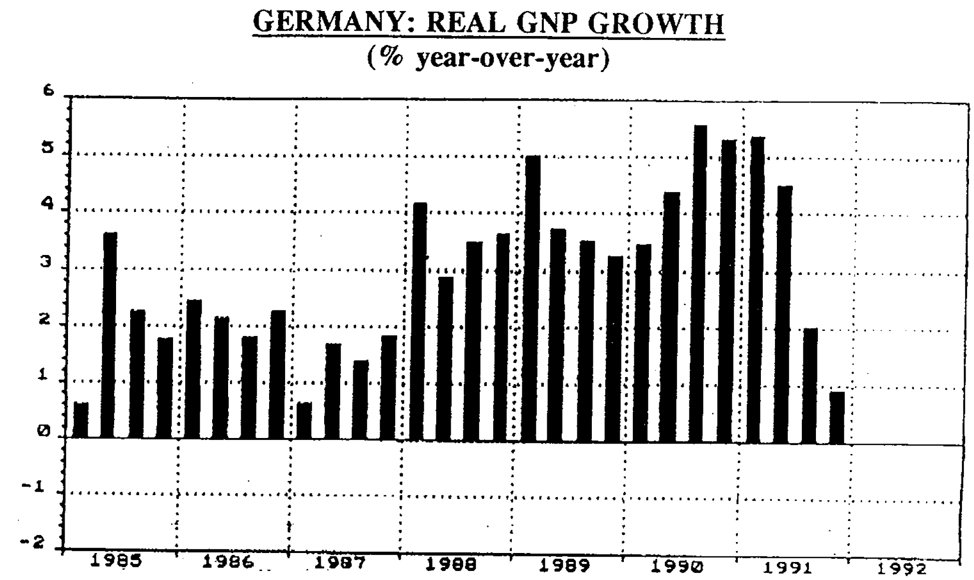
We think these hopes are misplaced, mainly for three reasons: firstly, the role of U.S. trade in Europe's business cycle is generally grossly overestimated; secondly, European monetary policy is now definitely determined in Frankfurt and no longer in Washington; and thirdly, the U.S. economy is in the maws of a long-term growth crisis, not just merely a temporal short-term cyclical recession.

As to the first point — the U.S. trade influence — just 7% of total exports of the European Community (EC) go to the United States (counting the export profiles of the countries separately). That's barely 2% of GNP in the EC. Britain's exposure at 12.6% is the highest. How big is the effect of a U.S. recovery? For example, in the U.S. boom-year of 1984, total European exports to the United States rose by a mere $3.3 billion. As an aside, Germany's exports to Belgium alone exceed those to the United States. Evidently, direct trade with the U.S. matters much less for the European business cycle than is the popular perception.

What used to link Europe's business cycle to that of the United States was in reality quite another mechanism: money. Europe's business cycle has closely tracked the U.S. business cycle in the past because European monetary policies closely tracked U.S. monetary policy. That largely had to do with the dollar's role as the world's key currency. In the final analysis, it was the easing of their own monetary and fiscal policies that pulled the European economies out of recession. But because that easing, for reasons explained, is presently delayed, the European economies are bound to stay sluggish. The popular idea that a U.S. recovery could and would instead pull Europe along is, and always was, grossly flawed.

RECOVERY SEMANTICS

What's far more important for both America and the world economy is the third point we made above: The U.S. economy is in a long-term growth crisis and not just in a short-term cyclical recession. This "growth crisis" is not something looming in a far-away future; it's here now with serious implications not only for people but for financial markets as well. One key implication is that U.S. short-term interest rates



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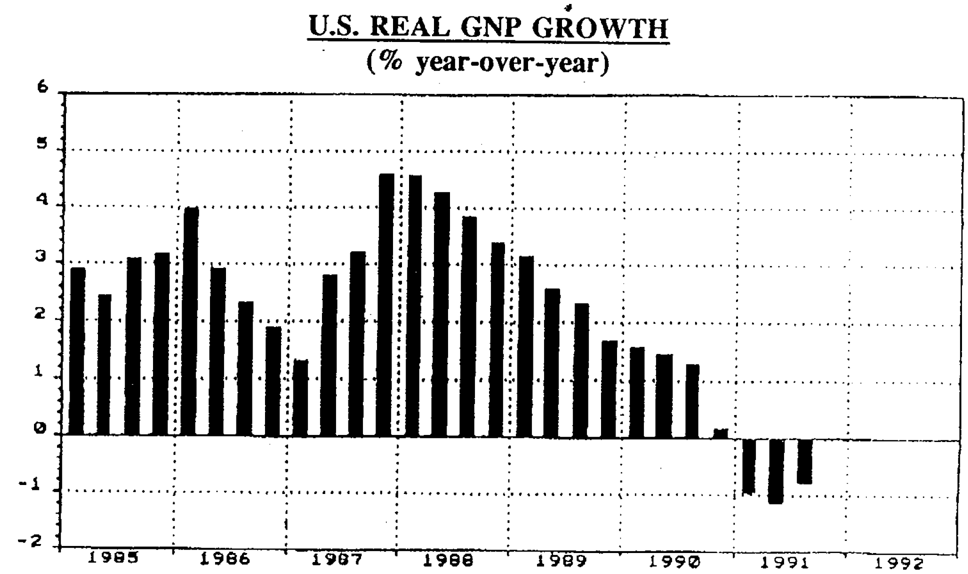


Source: Datastream

must remain at low, internationally unattractive levels and likely for quite a long time.

First, some clarifying remarks about the magic word "recovery". Just what constitutes a recovery? Recently, a critical article in the New York Times asked, "*From recession to what?*" Reading the many so-called optimistic forecasts, we began to realize that the experience of this unusually long period of economic stagnation has served to blur the old distinctions between recession and recovery. It's even reflected in the President's Economic Report which reads: "*With the President's pro-growth politics, the*

Administration expects real GDP to increase 2.2% from the fourth quarter of 1991 to the fourth quarter of 1992. This represents a significant improvement from the 0.2% growth during 1991 and the 0.1% decline during 1990."

As to the British economy, officially it's supposed to grow by 1% in 1992, that being made up of flattish growth in the first half and a firming to 2% in the second half. To be sure, compared with the prior two years of decline, that would be an improvement. But such anaemic recoveries are really more statistical than real. Above all, it seems pretty certain that recoveries starting at such a snail's pace will never reach the stage where they become self-reinforcing.

It's important to clarify this critical point: An economic recovery worthy of its name requires durability and momentum leading to higher employment and capacity utilization. In order for that to happen, an economy must grow at or above its potential growth rate. In the U.S. case, for example, the potential growth rate is now judged to be between 2 - 2.25% per annum. Anything below that means deepening recession — in other words, stagnating employment and capacity utilization.

U.S. ECONOMIC GROWTH CRISIS

What is a growth crisis? The following figures provide an answer. Between 1948 and 1973, the annual growth rate of U.S. national income was 3.9%. It was achieved through a 1.6% rise in employment and a 2.3% gain in productivity. 1973 appears to have been the watershed in America's economic development. In the following years up to 1980, economic growth then fell to an annual rate of 3%. But, the make-up of this growth changed radically. Productivity growth collapsed to an annual rate of 0.5% while labour force and employment growth — largely because of the baby boom — soared to 2.5% per annum. In the next decade, the 1980s, productivity growth improved a little to 0.8% while labour force and employment growth slowed to 1.7%. Result: average annual growth in the 1980s fell to 2.5%. Viewing the entire period from 1948, what we see is a slow but steady decline.

On this last point, we quote Prof. Allan H. Metzler from a recent testimony before a Congress committee: "*Our economic problem today is not the current recession; it is the slow average growth of per capita income for the past twenty years. Average compensation per hour, adjusted for inflation, increased only 3% in the sixteen years ending in 1989, after increasing more than 30% in the previous sixteen years."*

Given that creeping decline to date, what then, are U.S. growth prospects for the 1990s? In short, they stand to be the worst in U.S. history. Firstly, labour force growth is set to decline to a postwar low of about 1% a year due to demographic trends. Future U.S. economic growth therefore will depend more than ever on productivity gains. But for that, too, the outlook has never been poorer. Productivity gains are, over longer periods, closely associated with growth in the capital stock per employee. Since the mid-1970s, capital stock per employee has been growing at an annual rate of 0.8%, the lowest pace ever. In manufacturing, the growth of that measure has been even weaker. Short of an unlikely productivity miracle, America's economic growth in the 1990s threatens to be no better than the 1930s' average of 2%.

It's these type of long-term trends that investors (as opposed to short-term traders) should be guided by, rather than being buffeted to and fro by all the short-term statistical noise. U.S. long-term growth of only 2% over the long run has many wide and serious implications for monetary policy, interest rates, inflation, budget deficits and living standards.

. . . AND ITS DISASTROUS IMPLICATIONS

We don't see very much discussion about the long-term ramifications of such poor growth prospects for the U.S., least of all for financial markets. Yet, the uninspiring meekness of the more recent U.S. recovery forecasts certainly suggests a distinct general downgrading of expectations. Even the government has resigned itself to the realization that any recovery will be sub-normal.

But Wall Street wouldn't be Wall Street if it didn't spin this softening script into a rosy story. Investors have successfully been brainwashed to believe that slow growth is the best of all worlds both for bonds and stocks because it implies permanently low inflation and interest rates. That does make some sense, but only as long as it applies to the case of a temporary cyclical downturn. It becomes complete nonsense, though, when economic sluggishness turns chronic and secularly ingrained as presently in the Anglo-Saxon countries.

Here are some of the adverse dynamics of deteriorating growth potential and long periods of slow growth. Most of this set of symptoms applies to all of the early recession countries of Australia, Canada, the U.S., Britain, New Zealand as well as a number of others.

1) **Falling Savings.** Steadily slower income growth has probably played a role in decreasing private savings as people have endeavoured to defend their living standards by saving less and borrowing more.

2) **Rising Budget Deficits.** Slower economic growth is also part of the intractable budget malaise as lagging tax revenues coincide with rising spending pressures. If the U.S. economy had continued to generate income gains, the government budget would now be in surplus.

3) **Increasing Inflationary Bias.** Low savings, a high budget deficit and poor productivity growth make an economy increasingly inflation-prone. Inflation is being suppressed by economic sluggishness at the expense of business profits.

4) **Bias Towards Monetary Stimulation.** A low-investment, low-profit, low-growth economy over the long-run requires the almost-constant prodding of low interest rates. As already mentioned, that's why we have concluded that U.S. interest rates must remain at low, internationally-unattractive levels. That, in turn, means a long-term downtrend of the dollar. Instead of stimulating the economy, what low U.S. interest rates really reflects is the lower dynamism of the U.S. economy.

America, in other words, is trapped in a vicious circle of under-saving, under-investment and abysmal productivity growth. Actually, these have been America's core problems for almost 20 years. But there are two things that are new: firstly, as these structural deficiencies continue unchecked, they gather force; and secondly, low productivity growth now converges with low labour force growth. Until recently, formerly-high labour force and employment growth had largely masked the productivity debacle; now, as demographic trends slow, the economy is held hostage to its poor productivity growth.

MORE WALL STREET FAIRY TALES

But what about those jubilant Wall Street stories that have productivity advancing so wonderfully —

particularly so in the manufacturing sector — as companies trim their labour force. Well, it's another fairy tale . . . another of the many misconceptions by which Wall Street deludes itself and others.

To see that, one has to know the difference between the "micro" and the "macro" trends — that is the difference between the effects on single firms and the effects on the economy as a whole. Take the recent case of General Motors. The company plans to close 21 plants and cut 74,000 jobs representing about one fifth of its U.S. workforce.

Wall Street celebrated this announcement as a success story. After having lost $8.7 billion last year in North America, the company is anxious to improve its productivity and profits by eliminating unprofitable plants and slashing labour costs. It's hard to see, though, what GM and its shareholders will gain from such "pink-slip" productivity gains and the associated massive capital destruction. Common sense says that the economy as a whole will lose output and incomes . . . in other words, lose growth. It amounts to losing excess weight by cutting off one's limbs.

There are two basic ways of raising profits and productivity. Here is a contrasting illustration. Just when GM announced its long-term capacity shrinkage, Volkswagen, Europe's biggest car producer, announced a record-sized investment program for the years to 1995. GM seeks better productivity and profits by shrinking its production base; Volkswagen seeks the same mainly by investing and expanding.

As we all know, GM isn't unique by any means. Shrinking — or "downsizing", to put it into Wall Street's euphemistic jargon — has become the new grand strategy of many corporations and conjures up the image of hard-nosed managements making the U.S. economy super-competitive. *"In order to be competitive, we have to shrink,"* declared GM's chairman, Mr. Stemple.

In reality, "downsizing" is the way of least resistance to the pressure of foreign competition. Corporate America, instead of investing or fighting, writes off its defeats and runs. It's capitulation and resignation which has no equal in the world.

And to all of that Wall Street jubilates, which leads us to another familiar Wall Street fable: the grossly undervalued dollar. How can anyone reconcile this story of an immensely "undervalued" dollar with the long-term decline and now record-low profit margins of U.S. businesses, particularly so for manufacturing? How does a "cheap" dollar reconcile with this wholesale slaughter of American plant and employment? Why do so many American firms make their best profits in Europe and elsewhere, though the currencies there are said to be enormously overvalued?

It goes without saying that if U.S. industries were as internationally competitive as is generally asserted, they should be flooding world markets with their cheap products, especially so, given the weakness of domestic demand. As can be seen, all of these fables fly in the face of simple economic logic.

INCOME AND CREDIT — THE TWO STRATEGIC FACTORS

Yet, to repeat, the most important near-term issues presently are the U.S. recovery and the contrasting monetary policies of the United States and Germany. First though, in the case of the U.S., we should state that we have no intention of joining the frenzied and obsessive analysis of every statistical blip. We know too well that there is a lot of noise in these data due to dubious seasonal adjustments and the unique American habit of annualizing some monthly and quarterly figures which often serve to make mountains

out of molehills.

Nor, by the way, do we dispute the possibility of a short, temporary economic rebound taking form as happened last year. Even during the 1929-30 depression, each year had its abortive recovery provoking Schumpeter at the time to the comment: *"It is easy to understand that so long a decline should be interrupted by temporary rallies. Optimistic anticipation of people about 'recovery being around the corner' may also count for something in the explanation of a phenomenon of this order of magnitude."*

Rather than flitting about with short-term statistics, any serious analysis or debate ought to concentrate on the limited number of factors that are of strategic long-range importance. To select these, though, requires a little bit of thinking and theory. Broadly speaking, the potential for recovery in the first instance depends on rising spending power. That can only come about from two possible sources: rising income and/or credit. Without a strong boost from income and credit growth, a sustained self-reinforcing recovery is impossible.

Although this recession seems mild by conventional measures, its severity is masked by the fact that the U.S. economy has virtually stagnated for almost three years. Unusual, moreover, is the persistent, pronounced weakness in consumer spending. The typical postwar recession, in contrast, was primarily driven by a sharp but brief inventory liquidation. That's not the case this time.

CONFIDENCE IS NO SUBSTITUTE FOR MONEY

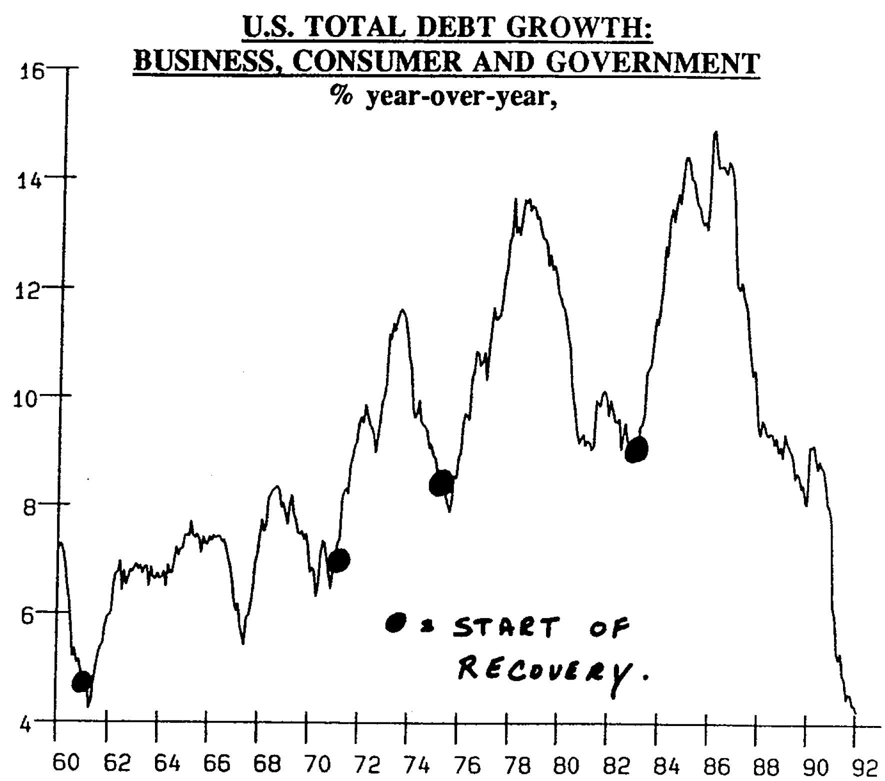
But why has the consumer retrenched? The most popular scapegoat favoured by policy-makers and economists is the plunge in consumer confidence. Apparently, many seriously believe that all that the economy needs to recover is a healthy dose of optimism; therefore, all the pep-talk about recovery. If this explanation proves anything, it's that an alarming ignorance exists about this recession's true causes. To make any sense out of this argument would imply that unwarranted fear alone is depressing the economy. And that's absolute nonsense.

Most obviously, the consumers' pessimism and retrenchment is firmly grounded in reality. Consumers spend less because they have adjusted to disappointing income growth given the fact that aggregate real disposable income has now been flat for almost three years. If you add to this income shortfall the growing job insecurity, the debt problems and the jitters about house prices, that's surely more than enough to explain the U.S. recession in a very simple and logical way. Consumer pessimism is the consequence of the recession, not its cause. Conversely, no amount of optimism will lift the U.S economy out of its doldrums as long as these income and credit drags remain.

Another question concerns the causes of this radical break in employment and income growth. These causes are too complex to be briefly dealt with here. Besides, we need the more detailed Flow-of-Funds statistics of the Federal Reserve for the fourth quarter to do so. But for the moment, we want to register that we see no meaningful upturn in job and income growth, nor do we see anything that points to such a possibility.

CREDIT STILL WORSENING

An accelerating credit expansion is the other absolutely indispensable condition for a durable recovery. What we see, instead, is the opposite: a progressive slowdown. During the three months to the end of



Source: ISI, Weekly Money Report, March 16, 1992

February, total debt rose only 3.3% at an annual rate, the lowest pace ever. The adjacent chart shows the disastrous credit situation from a long-term perspective.

What makes low credit growth even worse is its skewed mix — exploding government borrowing versus collapsing private borrowing. Since 1988, the public sector's share of total credit has soared from 30% to 70%. Literally, the government is the last sector with free and easy access to credit. This is a credit deadlock of unprecedented length and severity, and still, there is no sign of any reversal.

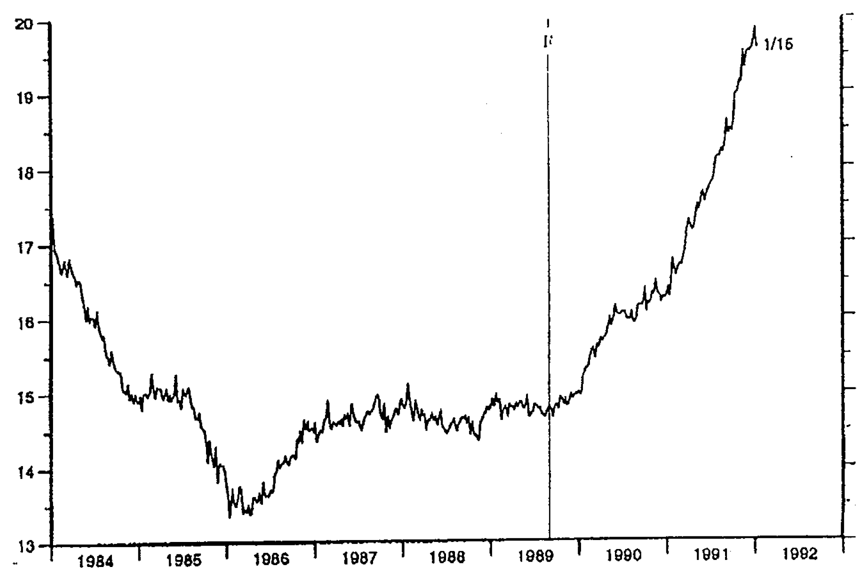
What are all those bullish economists saying to this worsening credit calamity? Actually, nothing at all. They ignore it and stress in its place the Fed's aggressive easing, the sharply higher bank liquidity and accelerating money growth. Citing past experience, they hail the rising banking liquidity as one of the guarantors of an imminent U.S. recovery.

Yes, bank liquidity is up sharply. But why? Because the banks are not lending to their customers. While their loans are shrinking, they are massively loading up on government bonds, piling more than $100 billion worth onto their balance sheets last year. Having burnt their fingers in the real estate market, holding government debt is very attractive to the banks since it requires minimal capital allocation under the new Bank of International Settlement (BIS) rules.

The important point to see here is that all the money pumped into the U.S. economy — showing up mainly in surging M1 — comes from bank purchases of government bonds. Not one single dollar of the current money creation results from bank lending to the private sector. But the new money thus created is not activated in the real economy. Most of it, apparently, either stays idle or fuels financial speculation. In sum, what the sharp rise in bank liquidity really reflects is not the Fed's success but its failure. The effects of easier money are not passed through to businesses and consumers. In trying to assess the effectiveness of monetary policy, it's crucial to distinguish between changes in bank liquidity and changes in non-bank liquidity. What counts for the real economy is solely the latter — the total liquidity of

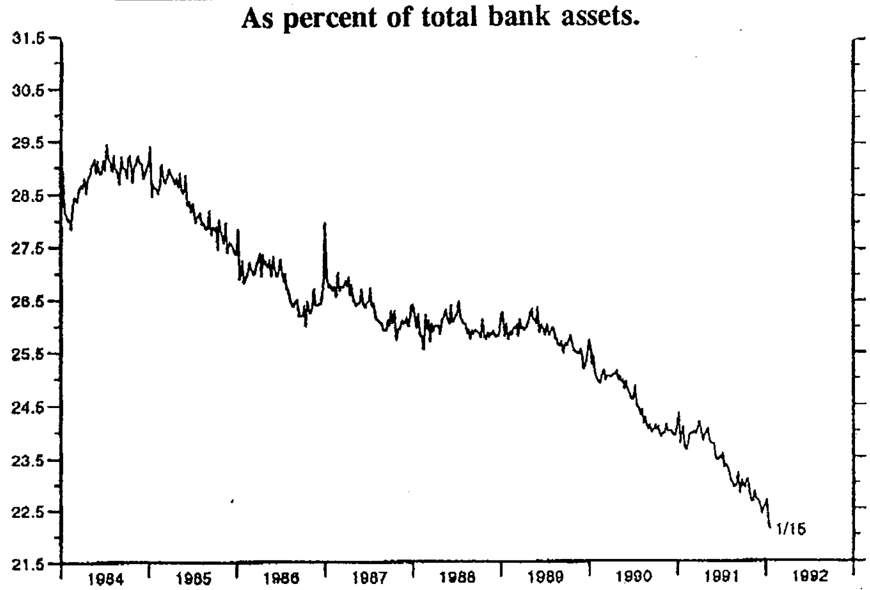
consumers and businesses as measured by the broad money aggregates. Growth in these money measures are at unprecedented lows. M4 is flat over the last 12 months while M3 has only grown by an anaemic 1%. Without the impact of the recently strong M1 component, broad money is actually contracting. And that's a serious development.

BANK LIQUIDITY RATIO
Percent



* Ratio of U.S. government securities to total loans and securities held by all U.S. commercial banks excluding trading account and total cash assets. Includes both Treasury and government agency issues.
Source: C.J Lawrence

U.S. COMMERCIAL AND INDUSTRIAL LOANS
As percent of total bank assets.



Source: C. J. Lawrence

This being an election year, the administration has opened its wallet. Combined with the large bank purchases of bonds, this increased spending has been boosting M1. It is probable that the current massive rise in government spending may give some lift to the economy. Doing so at the expense of a huge budget deficit is the kind of desperate policy action that makes things worse in the longer run. Considering the poor savings rate and the poor money growth in America, the handwriting on the wall is clear: a disastrous crowding-out of private investment is taking place.

CONCLUSIONS

The recent surges of both the U.S. dollar and U.S. stocks have been based on the perception of an imminent, healthy cyclical recovery and the expectation of an early reversal of the Bundesbank's high interest-rate policy. Both events look as far away as ever. In the U.S., credit growth

has not responded to easy money and low interest rates; in Germany, credit growth has not been slowed by tight money and high interest rates.

Hopes that the U.S. economy will again lead the global business cycle into recovery stand to be disappointed. The long-run outlook for the U.S. economy and its financial markets remains negative.

Economic worries are going global. Everywhere the key dynamics required for recovery are missing. Money and credit growth — with the exception of Germany — is generally at unprecedented lows. Europe remains restrained by high German interest rates and a downturn in Japan is gaining momentum.

Looking over a time-span of six months and longer, the dollar and U.S. stocks are most at risk. Both have been levitated by false recovery hopes, and now, as these hopes fade, are entering a dangerous phase. What's driving the U.S. stock market is not liquidity nor earnings but sheer fantasy.

Fantasy and psychology are fickle things, especially so, when fundamentals are horrible. Case in point: Last December, the Fed's interest rate cut miraculously kicked off a new euphoria; in Japan, however, a similar rate cut recently only deepened the gloom.

Worldwide, such conditions argue for investment in bonds, not stocks. Yet, opportunities and risks vary considerably by country.

Normally, this would be the ideal environment for the performance of U.S. long-term bonds, too. This time, though, the U.S. faces two dangers: firstly, a deluge of new government bonds; and secondly, the risk of a dollar crisis. U.S. bonds are therefore risky.

Taking a longer-term view, we can only repeat the recommendations made in the last letter: The safest investment today that offers high current yields and the potential for long-term capital appreciation are European hard-currency bonds. The insurance is this: The Bundesbank will ease rather too late than too early. That will keep European bond yields correspondingly high for a time though guaranteeing that the next big move in interest rates is certain to be down.

Next mailing: May 6th.

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Subscription and Administration Inquiries: Mulberry Press Inc. 7889 Sixteen Rd., Caistor Centre, Ontario, CANADA, L0R 1E0. TELEPHONE: 416-957-0602 FAX: 416-957-0602.

Annual Subscription Rates: 12 Issues. Europe: DM 600.00. Subscribers outside of Europe: $US 400.00
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